

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 16870
[Redacted])	
Petitioners.)	DECISION
)	
)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination issued by the staff of the Idaho State Tax Commission (Commission) dated July 10, 2002 denying a claimed refund in the amount of \$5,148 plus applicable interest for 1994 and asserting additional liabilities for Idaho income tax and interest in the total amounts of \$2,237 and \$3,194 for 1998 and 1999, respectively.

The only question for the Commission to decide in this matter is whether the petitioners had sufficient basis [Redacted] to allow them to deduct certain losses from an S corporation in which they held an interest. The petitioners claimed a net operating loss which they carried back to 1994. The disallowance of the losses from the S corporation eliminated the net operating loss that might otherwise have been available to be carried back to 1994.

The auditor made adjustments to disallow these claimed losses in the amounts of \$49,324 for 1996; \$106,785 for 1997; \$100,008 for 1998; and \$15,001 for 1999. For 1996 and 1997, these amounts were labeled on the 1099 issued by the S corporation as "LOSS IN EXCESS OF BASIS." The corporation had not filed Idaho income tax returns for 1999 and 2000 prior to the issuance of the Notice of Deficiency Determination by the auditor.

Internal Revenue Code § 1366(d) limits the losses a shareholder of an S corporation may claim:

(d) SPECIAL RULES FOR LOSSES AND DEDUCTIONS. –

(1) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK AND DEBT. – The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of –

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

The petitioners owned a 40% interest in [Redacted], an S corporation. The petitioners also owned a 16% limited partnership interest in [Redacted] owned a 25% interest in [Redacted] was the general partner in [Redacted] had losses during the years here in question. Most of these losses were attributable to losses from [Redacted] which flowed to [Redacted].

A taxpayer obtains basis in an S corporation both through stock and through debt. There is no question in this matter regarding the petitioners' stock basis. The only question concerns the amount of the petitioners' debt basis in [Redacted] A portion of this question is whether loans from [Redacted] to [Redacted] qualify to increase the petitioners' debt basis in [Redacted] The petitioners contend that these loans increase their debt basis. They have provided no authority to support this position.

The petitioners submitted copies of notes reflecting loans from several private parties to [Redacted] during 1997 and 1998. It appears that some of these loans to [Redacted] came from the petitioners. The notes from other private parties did not require the petitioners to be personally liable for the amounts due. The petitioners did provide documentation indicating that they paid amounts to the creditors on the notes in 2000, which is outside the scope of this decision.

It is not clear from the record why the petitioners feel that the loans from third parties to [Redacted] are relevant to the matter currently before the Commission. Apparently, the petitioners' position is, since they chose in 2000 to pay off the loans to [Redacted] (part of which had been loaned by [Redacted]) that this resulted in some fashion in sufficient debt basis to allow them to deduct the losses here in question in 1999. The Commission is aware of no authority which would authorize an increase in the petitioners' debt basis for loans to [Redacted] by third parties for which the petitioners bore no personal liability. It appears to the Commission that, even if the petitioners were in some way liable on the loans, this question is governed by the Tax Court's decision in Frankel v. Commissioner, 61 T.C. 343 (1973), affd. 506 F.2d 1051 (3d Cir. 1974). The Frankels owed interests in a subchapter S corporation and a partnership in identical proportions. The question before the court was whether loans from the partnership to the S corporation constituted an indebtedness within the meaning of Internal Revenue Code § 1374(c)(e)(B). The Court found that it did not:

The 'concept of indebtedness of the corporation to the shareholders as employed in the statute was intended to be comparable to actual capital investment by the shareholders,' Wheat v. United States, 353 F.Supp. 720, 722 (S.D.Tex. 1973). This indebtedness must run directly to the shareholder. The language of the statute is clear as to this requirement. That the actual debt basis should be determined on the basis of risk and its effects has not been proposed legislatively. See Note, 'An Approach to Legislative Revision of Subchapter S,' 26 Tax.L.Rev. 799, 821 (1971).

The situations where the indebtedness has been guaranteed, or runs directly to a trust or an estate, have all resulted in a denial of the loss passthrough to the extent of the debt. We think that a loan made by a partnership to the subchapter S corporation should receive the same treatment. If Congress should deem it appropriate to change [footnote omitted] the language of section 1374 so as to permit the risk of the debt to be the determinative factor in locating the proper subject for the basis adjustment, then fewer individuals would be caught in this trap for the unwary. However, where the language of the statute is clear and unambiguous, it is entirely reasonable to infer

that Congress deliberately intended the benefits of the subchapter S election to rest directly with those individuals who were the shareholders of their corporation. Where such direct language is used, we think the benefits of the passthrough are available only to those who satisfy the statutory requirements. Failure to do so will result in the loss of the benefit. See Hauptman v. Director of Internal Revenue, 390 F.2d 62, 65 (C.A. 2, 1962); Hewitt, 'Some Intriguing Recent Developments in Subchapter S,' 44 Taxes 848, 850 (1966) ('serious detriment to the taxpayer pervades the subchapter, and without constant and expert counsel (its) 'simplicity' * * * can change into nightmarish, if not ruinous, complexity.')

Frankel v. Commissioner, 61 T.C. 343 at 349-350 (1973).

The representative for the petitioners contends that Frankel is not relevant to this case. However, he provided no authority to support his position. He contends that, "the notes themselves set out [Redacted] as operating in the shoes of [Redacted]." The notes are all quite similar. [Redacted] The Commission finds nothing in the notes to indicate that Mr. [Redacted] is acting in any capacity other than as president of [Redacted]. The Commission finds that the implication of the loan made directly to [Redacted] by the petitioners is governed by [Redacted], *supra*. Both Frankel and Revenue Ruling 69-125, 1969-1 C.B. 207, make it clear that the indebtedness must run *directly* to the shareholder. The petitioners have failed to carry their burden of showing any such direct indebtedness. Therefore, the Commission finds that the petitioners are not entitled to additional basis for these loans. Accordingly, the net operating loss which the petitioners sought to carry to 1994 is not available.

WHEREFORE, the Notice of Deficiency Determination dated July 10, 2002 is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax, penalty, and interest (calculated to September 30, 2003):

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
1998	\$1,780	\$565	\$2,345

1999	2,696	659	<u>3,355</u>
		TOTAL DUE	<u>\$5,700</u>

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioners' right to appeal this decision is enclosed with this decision.

DATED this _____ day of _____, 2003.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2003, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]
[Redacted]

Receipt No.
